Internal Revenue Service

memorandum

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Brl:JDMacEachen

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to: Regional Counsel CC:MA
Attn: John A. Guarnieri

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Estate of [redacted] v. Commissioner
Docket No. [redacted]

This is in response to your request for Tax Litigation Advice regarding the subject case, and confirms our response provided in a telephone conference of April 25, 1991.

FACTS

[redacted] (decedent) died [redacted] Respondent determined a deficiency in estate tax of roughly $[redacted] based largely upon the determination that the value of certain closely-held stock was $[redacted] per share rather than the $[redacted] claimed by the estate. The question presented is whether the estate tax value of the shares is controlled by the terms of a shareholder agreement dated [redacted]

At the time of his death decedent owned [redacted] shares of voting common stock and [redacted] shares of nonvoting common stock of [redacted]. [redacted], a holding company, is the sole shareholder of [redacted], [redacted], [redacted] and [redacted], all manufacturers of [redacted]. The remaining shares are held by decedent's wife and [redacted] sons.

Originally, [redacted] was the parent company. On [redacted] [redacted] and its [redacted] shareholders, (also decedent, his wife and [redacted] sons) executed a shareholder agreement to restrict the transferability of the common stock of [redacted], ostensibly to assure the continued management of the corporation. The [redacted] agreement provided that any shareholder who wanted to dispose of his stock, or whose stock was subject to transfer by operation of law, was obliged to offer the stock to the remaining shareholders, who could purchase the shares in proportion to their then-current holdings at a price determined by a formula. Any shares not so purchased could be purchased by the corporation. However, if more than [redacted] percent of the voting stock was for sale, the corporation was required to purchase all of the unpurchased voting shares. These restrictions applied to testamentary as well as *inter vivos* transfers. The formula price was generally equal to the book value of the stock, excluding the value of intangible assets, as determined by the last audited annual statement.

In [redacted], pursuant to a reorganization, [redacted] became a subsidiary of a holding company, [redacted]. On [redacted], the [redacted] shareholders, who were the same as the former [redacted] shareholders, executed a new shareholder agreement. The [redacted] agreement was substantially the same as the prior agreement, except that the [redacted] agreement gave the right of first refusal to the corporation, and not to the shareholders. However, if the offered stock represented more than [redacted] percent of the corporation's voting power, the corporation was obliged to purchase it. It is the effect of this latter agreement which is at issue in this case.

ANALYSIS

The fair market value of closely held stock may be established for estate tax purposes by an enforceable agreement that fixes the price at which a decedent may transfer his interest during life, provided that his estate can receive only the price set by the agreement for the stock after his death and the agreement is not a substitute for a testamentary disposition. Lomb v. Sugden, 82 F.2d 166 (2d Cir. 1936); Wilson v. Bowers, 57 F.2d 682 (2d cir. 1932); Estate of Bischoff v. Commissioner, 69 T.C. 32 (1977). In short, the restrictive agreement must have been entered for *bona fide* business reasons, and must not be a substitute for a testamentary disposition. These conditions are conjunctive; both must be satisfied. St. Louis County Bank v. United States, 674 F.2d 1207 (8th Cir. 1982).

The court has calendared this case for further trial on [redacted]. The focus of this hearing will be whether the agreements were a device to pass decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. The resolution of this question will be determined by the intent of the parties when they entered into the agreements.

One of the elements in determining whether the agreements are testamentary in nature is the extent to which they resemble a gift to be completed on death. A tentative transfer occurring on the execution of an agreement which is not offset by consideration in money or money's worth is highly indicative of a testamentary intent. In this case there is no real consideration. The mutual covenants agreed to by the parties, far from constituting consideration, are the very vehicle through which a transfer from parent to child will occur. However, the testamentary nature of the transaction is best evidenced in that which passes on the signing of the agreement. Accordingly, a disparity between the fair market value of the stock prior to signing the agreement and the formula price chosen, if substantial, is highly indicative of a testamentary intent on the part of all concerned.

In establishing the disparity between the pre-agreement fair market value of the shares and the formula price, restrictions placed upon the sale of the stock by the [redacted] and [redacted] agreements need not be considered. This is obvious with regard to the [redacted] agreement, for the very question presented is the difference in stock value before and after the agreement was executed. Compare Benzel v. Commissioner, 36 B.T.A. 246, 253 (1937), aff'd, 100 F.2d 639 (3rd Cir. 1938); Estate of Bischoff v. Commissioner, 69 T.C. 32, 41 n. 9, (1977) (at the time the restrictive agreements were entered, the formula price was chosen at arm's length and was reflective of the then-current fair market value of the stock).

However, this proposition is a bit more problematic with regard to the [redacted] agreement. It can be expected that petitioner will argue that as it is the [redacted] agreement at issue in this case, the inquiry must be made in [redacted], and the comparison must be between the value of the stock prior to the [redacted] agreement and the value as determined under the agreement. As the pre-agreement value of the stock was controlled by the [redacted] agreement, and both agreements employ the same valuation formula, petitioner will argue that in [redacted] no disparity existed.

There are several responses to this argument. Both agreements are part of a single integrated estate plan, which was first implemented in [redacted]. The [redacted] agreement was the consequence of an unrelated event, the later recapitalization of [redacted], and is merely in furtherance of the original plan. The entire course of events must be viewed as a whole and tested at each point for testamentary taint. A disparity in [redacted] between the fair market value of the stock and its value determined under the agreement is simply further evidence of testamentary intent. It would make little sense under this approach to consider the effect of the tainted [redacted] agreement determining whether the [redacted] agreement suffers from the same taint.

This is the preferred approach, and one which is consistent with the facts as developed. More importantly, this seems to be the approach used by the court in Estate of [redacted] v. Commissioner, T.C. Memo. [redacted]. The court does not discriminate between events relating to the [redacted] agreement and those relating to the [redacted] agreement. Further, the court does not distinguish between the agreements themselves, simply referring to them as 'the agreements'. See [redacted]

In the alternative, it can be argued that the [redacted] agreement is of independent significance for estate tax purposes. Upon the [redacted] recapitalization, the [redacted] agreement became meaningless, as the [redacted] shares were no longer directly held by the family. Faced with the termination of the [redacted] agreement, and the frustration of the prior estate plan, the family chose to subject their new shares to a new agreement, the [redacted] agreement. As the [redacted] agreement was not an integral part of the recapitalization, and was independent of the [redacted] agreement, it is entirely appropriate to ignore the [redacted] agreement in testing the [redacted] agreement for testamentary taint.

CONCLUSION

Intrafamily contracts must be subjected to strict scrutiny when testing to determine if they are bona fide. Thus, we agree that it is appropriate to compare the fair market value of the stock unrestricted by the [redacted] agreement with the value of the stock as determined under either the [redacted] agreement or the [redacted] agreement in determining the testamentary intent of the parties in entering the agreements. However, we suggest that respondent's experts be prepared to address the disparity of stock price, if any, assuming that the [redacted] agreement is a factor in determining the [redacted] pre-agreement fair market value of the stock. This issue is likely to arise on cross-examination.

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